APPENDIX F
ENCOURAGE STRONG GOVERNANCE AND BEST PRACTICES FOR EXEMPT ORGANIZATIONS

Overview

The Discussion Draft includes a number of proposals intended to strengthen corporate governance and responsibility within the charitable sector.[1] These proposals are informed by the American Competitiveness and Corporate Accountability Act of 2002 (commonly referred to as the Sarbanes-Oxley Act or, as in this paper, "SOX"), which (among other things) establishes corporate responsibility standards and procedures for boards of directors and officers of public companies.[2] An objective of SOX is to restore integrity and public confidence in corporate governance, financial statements and stock valuations of public companies following Enron and other corporate scandals. Much has been written about the implications of SOX to charitable organizations,[3] and a number of states are considering legislation to apply various concepts from SOX to nonprofit organizations within their jurisdiction.[4]

Strong governance is just as essential in the charitable sector as it is for public companies, and the Discussion Draft builds on efforts by state regulators and indeed within parts of the sector itself to bring these issues to the fore. The challenge is to determine how best to achieve the goals of the Discussion Draft – to encourage strong governance and best practices – within a sector that is considerably more diverse than public companies. While public companies have, by definition, many common operating characteristics and a single overriding mission that is purely economic in nature – to provide a financial return to their owners/shareholders – the charitable sector is far more varied in size, resources, operational characteristics, and mission, making it virtually impossible to have "one size fits all" rules. Although some charities are sophisticated, multi-billion dollar organizations, the overwhelming majority are small, community-based, and in many cases run by volunteers. Churches and religious organizations comprise the largest component of the sector, and the governance models of many of these organizations are inextricably bound with their religious beliefs and traditions.

The diversity of the charitable sector is one of its strengths, allowing as it does not only for the establishment of institutional charities with long-term goals and objectives to serve broad and on-going public needs, but also for the creation of community organizations that are

---

[1] Charitable organizations may be created in trust rather than corporate form. The Discussion Draft does not consider how corporate governance provisions would be adapted for the trust model.

[2] 15. U.S.C. §§ 7201 *et seq*.

[3] *See, e.g.*, McDowell, Suzanne Ross, "Should Nonprofit Organizations Adopt the Rules of Sarbanes-Oxley?" *Taxation of Exempts* (July/Aug. 2004); "The Sarbanes-Oxley Act and Implications for Nonprofit Organizations," Board Source and Independent Sector (2003); Heinz, Patrice A., "The Financial Reporting Practices of Nonprofits," Alliance for Children and Families (2003); McLaughlin, Thomas A., "For-Profit Spillover: New Regulation and Independence," *NonProfit Times* (February 2003); Michaelson, Martin, "A New Era of Corporate Governance Bears Down on Higher Education," *Trusteeship* (Jan./Feb. 2003); Peregrine, Michael W., "Taking the Prudent Path: Best Practices for Not-for-Profit Boards," *Trustee* (Nov./Dec. 2003).

[4] For example, in California the Attorney General has proposed the "Charity Integrity Bill" and the "Nonprofit Integrity Act of 2004, CA Senate Bill 1262" was introduced; the Connecticut Legislature introduced H.B. 5313; in Hawaii, the Attorney General proposes legislation that would give the Attorney General the authority to remove directors; in Massachusetts, the Attorney General is proposing the "Act to Promote the Financial Integrity of Public Charities;" and in New York, the Attorney General has proposed the "Nonprofit Accountability Act" and the legislature has introduced S. 4836 on behalf of the Attorney General.

directed to specific immediate needs and have a limited period of existence. Disaster assistance organizations are just one example of the latter. The diversity of the sector extends not only to type of organization, but also to financial resources, which are limited for many charities. While it is essential that all charitable organizations devote sufficient resources to achieving strong governance – and indeed doing so can be expected to enhance the ability to accomplish charitable purposes – it is nonetheless the case that every dollar spent on governance is a dollar drawn away from mission. This places a premium on developing a cost-effective strategy for encouraging strong governance.

Various current legal standards are directed to achieving good governance within the charitable sector. These include the application of common law fiduciary duties for directors and officers;[5] various state laws directed to corporate governance that are enforceable by state attorney generals; and provisions of the Internal Revenue Code that prohibit private inurement and private benefit and establish excise tax penalties on officers and directors for certain misconduct.[6] Many of the concerns raised in the Discussion Draft might well be addressed through a robust enforcement effort by the IRS and/or state regulators. An often-cited problem is the lack of such enforcement, commonly attributed to an insufficiency of resources at the federal and/or state level. Other provisions of the Discussion Draft seek to address this problem by directing additional funding to the IRS and to state regulators. The ABA Section of Taxation has long supported the provision of sufficient funding for the IRS – including the Exempt Organizations Division – and we hope that provisions in the Discussion Draft directed to this issue will receive immediate attention within the appropriate congressional committees. Indeed, without the provision of adequate funding for enforcement, there is limited value in enacting additional federal legislation in this area.

One means of achieving transparency, accountability and good governance for public companies is through disclosure. Public companies file quarterly and annual reports with the Securities and Exchange Commission; these filings require disclosure of significant financial and narrative information that is intended to promote informed investment decisions. SOX – as well as rules enacted by the stock exchanges following the passage of SOX – provides for enhanced public disclosure to better achieve the intended objectives. Disclosure is also an important means for achieving transparency, accountability and good governance in the charitable sector. Charitable organizations (other than churches and very small publicly supported charities) are required to file annually IRS Form 990 (or 990-PF in the case of private foundations), disclosing a significant amount of information about the organizations, including the names of board members, compensation of officers, directors and the five highest-paid employees, program accomplishments, information about operational matters relating to exempt status requirements and financial data. These Forms are required to be made available to the public upon request and, for the last few years, have been available on-line at www.GuideStar.org. The easy accessibility of Forms 990 and 990-PF has contributed to in-depth media coverage of the charitable sector. As discussed above, other provisions of the Discussion Draft offer thoughtful options for enhancing the Forms 990 and 990-PF so that they

---

[5] *See Guidebook for Directors of Nonprofit Corporations*, Second Edition, Nonprofit Corporations Committee, ABA Section of Business Law.

[6] *See* I.R.C. §§ 501(c)(3), 4941, 4958.

will serve as better tools for their various constituencies (including the public, the media, the IRS and state regulators).

The strength of governance within the charitable sector ultimately rests on the ability of charitable organizations to attract and retain directors and trustees who are knowledgeable about their responsibilities and willing to devote the necessary time and attention to discharging them, frequently on a volunteer basis. From time to time, concerns have been raised about the difficulties of some charities in finding individuals willing to serve on their boards, at least in part due to the potential liability associated with board service. States have attempted to address this concern by adopting various volunteer immunity provisions which limit the liability of volunteer directors,[7] and in 1997, Congress passed the Federal Volunteer Immunities Act for the same purpose.[8] As the Discussion Draft considers various options for encouraging strong governance in the charitable sector, another challenge will be to do so in a manner that does not discourage individuals from taking on the responsibilities associated with board service in the charitable sector.

Specific Comments

Board duties.

The Discussion Draft provides general statements about the role of the board of directors in managing a charitable corporation, and the fiduciary duties owed by directors. These appear to be consistent with current law. It then introduces a new concept that directors who have "special skills or expertise" would have a duty to use such skills or expertise, and provides for the creation of federal liability for breach of director duties.

With respect to the subject of compensation, the Discussion Draft provides that any compensation consultant hired by a charity should report to the charity's board and should be independent. It also provides for annual reviews of compensation, and for public disclosure and justification of compensation.

The Discussion Draft lists a number of specific board responsibilities, some of which appear to be encompassed within basic fiduciary duties (e.g., "the Board must establish basic organizational and management policies and procedures of organization and review and proposed deviations," "the Board must oversee the conduct of the corporation's business and evaluate whether the business is being properly managed") and some of which are quite specific and go beyond current requirements and indeed beyond the requirements of SOX (e.g., "an independent auditor must be hired by the Board and each such auditor may be retained only for five years").[9]

---

[7] *See, e.g.,* Code of Ala § 6-5-336; Alaska Stat. § 09.65.170; Cal. Gov. Code § 5239; Conn. Gen. Stat. § 52-557m; 10 Del. C. § 8133; D.C. Code § 29-599.15; Fla. Stat. § 768.1355; Idaho Code § 6-1605; Indiana Code §§ 34-30-4-1, -2; K.R.S. § 411.200; Md. Code § 5-407; Minn. Stat. § 317A.257; Mont. Code Ann. § 27-1-732; N.J. Stat. Ann. § 2A:53A-7; N.M. Stat. Ann. § 53-8-25.3; N.C. Gen. Stat. § 55A-8-60; N.D. Cent. Code § 32-03-44; 18 Okl. Stat. § 866, 867; R.I. Gen. Laws § 7-6-9; S.D. Codified Laws § 47-23.21; Tenn. Code Ann. § 48-58-601; Tex. Code § 84.004; Utah Code § 78-19-2; VA Code Ann. § 13.1-870.1; Rev. Code Wash. § 4.24.264; Wyo. Stat § 1-1-125.

[8] 42 U.S.C. § 14503(a).

[9] Section 203 of SOX requires rotation of the lead audit partner every five years and not a change in the auditor.

The Discussion Draft indicates that all of these requirements "must be confirmed" on the Form 990, and notes that relaxation of certain of these rules might be appropriate for smaller organizations. It does not specify any penalty that might be imposed for an organization (or its board) for failure to meet the specified board responsibilities. It also does not indicate whether the proposed new federal liability for breach of duties would encompass a failure to comply with the specific listed responsibilities.

The concept in the Discussion Draft that the Form 990 could be used as a vehicle to promote strong governance and best practices is appealing for a number of reasons. First, in terms of reaching the sector, the Form 990 is required for all but churches and the smallest charities,[10] and including a governance section on the Form 990 would be a significant tool in encouraging voluntary compliance with best practices. For example, assume the Form 990 is modified to include a question such as "Does the organization have and follow a conflict of interest policy which prohibits officers and directors from participating in any decision as to which they have a conflict of interest? _____ yes _____ no. If no, please explain." There is little doubt that this would put considerable pressure on those who don't have such a policy to adopt one rather than check "no" on the Form. Indeed, SOX uses a similar approach by requiring public companies to disclose whether or not they have adopted a code of conduct for senior financial officers.[11] Moreover, including a governance section on the Form 990 would allow the IRS to educate charities on the importance of this issue through the Form 990 instructions.

Second, such disclosure would provide important information to the public, as individuals decide how to direct charitable contributions, and to the media as they decide which charities may warrant further scrutiny.

Third, such disclosure would help regulators (state attorney generals and the IRS) decide where to target their enforcement efforts. It would also provide a solid base of information as to current governance practices in the charitable sector that could help inform whether there is, in fact, any need for federal or state legislation or regulation in the area.

As discussed above, other provisions of the Discussion Draft are directed to making the Form 990 a more useful tool in promoting accountability and transparency, and expanding the Form to include a well-drafted section asking for information about basic corporate governance standards would be an appropriate part of that effort.

Other concepts in the Discussion Draft, however, warrant reconsideration because of their potential for causing unintended results. For example, the proposal to establish a federal liability for breach of fiduciary duty might well make it significantly more difficult for charities to attract and retain the very type of directors that are necessary to achieve the goal of strong governance.[12] Given the existence of long-established common law fiduciary duty standards, it is unclear what would be gained by adding a provision for federal liability.

---

[10] Form 990-EZ is a simplified version of Form 990 for smaller charities that are above the nonfiling threshold.
[11] Section 406 of SOX.
[12] See Appendix G's discussion of the risks of adopting the private relator approach.

The proposal to require directors who have special skills or expertise to use those skills raises similar – as well as other – concerns. Following the enactment of SOX, the boards of many charitable organizations have established independent audit committees and, if they do not already have directors with SOX-type financial expertise, are seeking to add directors with such expertise to their audit committees. The establishment of what appears to be a higher standard of care for directors with special expertise (such as financial expertise, investment expertise, legal expertise) would likely make it more difficult for them to attract and retain directors with such expertise. Moreover, there is a real danger that such a provision would create an expectation within a board of directors that there should be deference to those who have special skills and expertise, which would deprive the organization of the benefit of input from other directors.

Finally, with respect to the provisions concerning the compensation process, we note that the Form 990 already requires disclosure of the amount of compensation paid to officers, directors and five highest paid employees of charitable organizations. What the Form 990 does not require is disclosure of information about the compensation process itself. The IRS regulations under Section 4958 set forth a three-part process for boards to follow in determining compensation for officers, known as the "rebuttable presumption" procedures[13] and if the Form 990 is modified to include a section on corporate governance, it would be helpful to include a question as to whether the board follows the process outlined in those regulations. If the answer is no, the organization should explain why not. That would not only encourage charities to follow the procedures established in the legislative history and regulations under Section 4958, but also would alert the public, the media and regulators as to organizations that are failing to follow such standards. This seems to provide the appropriate level of public disclosure, without requiring disclosure of what would amount to full-blown compensation studies.

Board composition.

The Discussion Draft proposes various requirements relating to board size (no fewer than three, no more than 15), the role of compensated directors (who cannot serve as board chair or treasurer), and the number of independent directors (for public charities, at least one director or one-fifth of the board).

The Discussion Draft's objectives appear, for the most part, to be clearly related to strong and effective governance. The proposed limits on board size seem designed at the lower end to make sure that control is not vested in just one or two people, and at the upper end to make sure that the board is not so large as to be unwieldy. The requirement to have a certain number or proportion of independent directors in the case of public charities seems designed to make sure that such organizations have the type of "public" control that is intended to distinguish them from private foundations. And while the purpose of the prohibition against having the board chair and treasurer be compensated is less clear, it may relate to the desire to have those positions filled by directors who are not also employees of the charity.

---

[13] The regulations provide a "presumption of reasonableness" for compensation determinations made in accordance with the established process, which requires (1) independence, (2) use of comparable market data, and (3) documentation of the basis for the compensation determination. Treas. Reg. § 53.4958-6.

Given the diversity of the charitable sector, however, it is difficult – if not impossible – to adopt "one size fits all" rules with respect to a matter as fundamental to strong governance as the composition of the board. For example, many large charitable organizations have boards of more than 15 directors and consider that to be essential to good governance. Colleges and universities, for example, often have boards with more than 15 directors, with a board committee structure that allows subsets of the board to exercise oversight over specific aspects of their operations. Service on board committees typically requires a significant commitment of time over and beyond that required for full board meetings, and board members typically serve on no more than two or three committees to allow them to spend the necessary time on committee as well as board service. The objective of the Discussion Draft – to encourage large boards to develop an effective model of governance – might be accomplished by including a question on a new governance section on board committee structure (e.g., "List the names of any board committees") or requiring the list of directors to include the board committees on which each director serves.

With respect to having a minimum board size, this is, as a threshold matter, a question of state law. Some states require a minimum of three directors for nonprofit corporations,[14] while others require only one.[15] In our experience it is typical for public charities to have more than one director, and we note that the IRS closely scrutinizes Form 1023 applications for exemption from organizations that have fewer than three directors, occasionally requiring expansion of the board as a condition of exemption. There are, however, some cases in which a board of fewer than three directors may be appropriate, including in the context of church-related and religious organizations where the minister may be the sole director. Here, too, including a question in a corporate governance section of the Form 990 asking for an explanation as to why an organization has fewer than three directors might encourage board expansion, as well as provide a useful base of information that would help to inform federal and state regulators as to whether legislation might be useful, as well as what exceptions might be appropriate.

With respect to the subject of independent directors, we note that it might be difficult for some charities to meet the rather expansive definition of independence suggested in the Discussion Draft. For example, private schools whose boards are drawn from parents of the student body might not meet the independence standard contained in the Discussion Draft. We also recognize that the adoption and implementation of conflict of interest policies that prohibit board members from participating in decisions about which they have a financial conflict of interest is a fundamental hallmark of strong governance. By encouraging the adoption of such conflict of interest policies through appropriate Form 990 disclosure (as described above), and possibly by asking an additional question about whether the organization has an independent audit committee and if the answer is no, why not, charities would be encouraged to adopt and follow best practices voluntarily.

---

[14] *See, e.g.,* Alaska Stat. § 10.20.086; Ala. Code § 10-3A-35; Con. Gen. Stat. § 33-1003(a); Hawaii Rev. Stat. § 415B-62; Fl. Stat. § 617.0803.

[15] *See, e.g.,* Rev. Code Wash. § 24.03.100.

Board/officer removal.

The Discussion Draft proposes that individuals who are not permitted to serve on the boards of public companies, or who have been convicted of certain federal or state offenses, not be permitted to serve as an officer or director of a tax-exempt organization. An organization or its officers/members who knowingly retained such a person would be subject to penalty.

It also proposes that the IRS would have the authority to remove an officer or director who has been found to have violated self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation laws, and that an organization that knowingly retained a person not permitted to serve would lose its tax exemption or be subject to some unspecified lesser penalty.

We note that there is a tradition, within the criminal justice system, of allowing individuals to pay back society for wrongdoing through community service, often with charitable organizations. We recognize, however, that in the typical case this does not include service as an officer or director of a charity. The Discussion Draft raises a legitimate question as to whether individuals not permitted to serve on the boards of public companies – or who have been found guilty of certain other offenses – should be similarly prohibited from serving on the boards of charitable organizations. There are thoughtful arguments to be made on all sides of this issue. The short time available for comment on the Discussion Draft does not allow us to do more than acknowledge the complexity of this issue.

Under current law, the IRS does not have authority to remove individuals as officers or directors. The self-dealing rules under Section 4941 and the intermediate sanctions rules under Section 4958 provide for excise tax penalties that are intended to penalize violations and to ensure that the organizations are made whole. While the intermediate sanctions rules are applicable only to cases where an officer or director has received an excess benefit from the organization, the self-dealing rules may apply to situations where there has been no economic harm to a private foundation, and indeed where the transaction may have provided it with an economic benefit.[16] Typically any violation of the prohibition on private inurement would also be a violation of the self-dealing and/or intermediate sanctions rules. Current law does not penalize "conflict of interest" transactions if there is no violation of the self-dealing or intermediate sanctions rules.

The proposal in the Discussion Draft to allow the IRS to remove an officer or director for any violation of provisions described above appears to be unnecessarily overbroad, since the self-dealing and intermediate sanctions rules provide an appropriate remedy, at least for violations that are not repeated and willful. In the rare case where such violations are found to be repeated and willful, however, granting the IRS authority to require the removal of an officer or director might offer an appropriate alternative to revocation of an organization's tax

[16] For example, the self-dealing rules of Section 4941 would penalize an officer or director who rented office space to a foundation on a below market basis, even for $1 a year.

exemption. Indeed, there is anecdotal evidence that the IRS has sought to exercise such a remedy on occasion in the context of a closing agreement negotiation.[17]

Government encouragement of best practices.

The Discussion Draft proposes to require federal agencies, in awarding contracts and grants to tax-exempt organizations, to give "favorable consideration" to those accredited by entities designated annually by the IRS as establishing best practices for tax-exempt entities. Along the same lines, the IRS (in consultation with OPM) would establish best practice / governance / accreditation requirements for organizations seeking to participate in the Combined Federal Campaign.

As discussed below, the Discussion Draft places significant reliance on the ability of various nonprofit accrediting organizations to encourage best practices within the charitable sector. We recognize the value of such organizations in encouraging voluntary compliance with best practices. Given the size and diversity of the charitable sector, however, we question whether IRS approval of accreditation organizations is the best use of scarce IRS resources or the best way to establish high standards of corporate governance. Moreover, we are uncertain that an organization's adherence to standards set by an accrediting organization would necessarily mean it is better able to carry out the purposes of a particular federal contract or grant program.

With respect to the Combined Federal Campaign, this is an important service that the federal government provides to the charitable sector and to federal employees who wish to contribute to that sector. However, as discussed below, we believe that standards of best practices will be most effective if established by appropriate segments of the charitable sector itself and that tying government benefits and penalties to those standards could undermine efforts to encourage excellence in corporate governance. For this reason, we have concerns with making adherence to accreditation standards a prerequisite to participation in the Combined Federal Campaign.

Accreditation.

The Discussion Draft would provide $10 million to the IRS to support accreditation of charities nationwide, in states, and of particular classes of charities. The IRS would have a great deal of latitude in designing or approving an accreditation program. It could initiate its own efforts or solicit requests. It would have authority to contract with tax-exempt organizations to develop and manage accreditation programs. Accreditation programs could operate on a membership basis and require dues to defray expenses and could take corrective action. The Discussion Draft indicates that the IRS proposal should encourage initiatives that are taking place at the state level. Finally, the Discussion Draft provides that the IRS would have authority to base charitable status or eligibility for charitable donations on whether an organization is accredited.

---

[17] *See* Brody, Evelyn, "A Taxing Time for Bishop Estate: What Is the I.R.S. Role in Charity Governance?" *University of Hawaii Law Review*, Vol. 21 No. 537 (2000).

In the wake of recent scandals and media reports, there have been many efforts to articulate standards of best practices for nonprofit governance. In addition, there have been efforts to encourage charities to adopt such standards.

The Discussion Draft refers to one such effort. Specifically, it references the Standards for Excellence Institute, a division of the Maryland Association of Nonprofit Organizations, which has published *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector*. This code was developed by a team of volunteers from the nonprofit sector and covers eight areas of operations with 55 specific performance standards. It has been adopted, with modifications, in six states. Nonprofit organizations can apply for a "Seal of Excellence" which indicates that the charity has met the standards set forth in the code.

Another standard setting effort has been undertaken by the BBB Wise Giving Alliance, an organization whose CEO testified at the Senate Finance Committee hearings on June 22, 2004. This organization, which has published *Standards for Charity Accountability*, monitors tax-exempt organizations and publishes reports on whether or not they meet these standards. Its goal is to provide potential donors with useful information for evaluation of charities. Tax-exempt organizations that meet the BBB Wise Giving Alliance standards may display a seal of approval (subject to signing a licensing agreement and paying a fee).

Defining best practices in corporate governance and encouraging their adoption by charities is a laudable objective. Those organizations that are well governed should be the most successful in achieving their missions – and that is the ultimate goal on which we should all be focused. As with so many of the issues that face the charitable sector, the challenge is to achieve this objective in a cost effective manner that recognizes and preserves the diversity and the plurality of the sector. The Discussion Draft appears to recognize this challenge and to recognize that there are many ways to encourage best practices.

An accreditation program raises a host of issues, many of which are suggested by the Discussion Draft. Who will be the accrediting organization or organizations? Who will monitor the accrediting organizations? Who should set the standards? Should there be one nationwide standard or should standards be set at the state level? Should different subsectors of the charitable sector have different standards? What happens if we end up with conflicting standards? Who decides which standard should prevail? Is it possible to set "bright line" standards that will truly encourage excellence in corporate governance?

We believe that government should encourage charities to answer these questions themselves by establishing their own standards of best practices and their own methods for promoting and encouraging the adoption of such standards. We have not had time to research the extent to which self regulatory bodies exist in the charitable sector today, but our impression is that self regulation with respect to nonprofit corporate governance is relatively new and is not widespread. At the same time, at least some of these efforts appear to be receiving favorable reports.[18]

---

[18] See, e.g., "Sealed for Good," *The Chronicle of Philanthropy*, April 3, 2003, p 21.

Thus, we believe that IRS or other government grants to support accreditation programs should be made to organizations that will operate as membership organizations and will establish standards of best practices and systems of accreditation and regulation with input and ongoing feedback from their members. This approach would permit organizations that view themselves as having common issues to come together to regulate themselves and would permit periodic re-evaluation of the standards, much as a corporation's governance committee evaluates a specific corporation's governance on a regular basis. For the IRS to undertake an effort to establish or review standards for the entire charitable sector would be a huge undertaking that would divert scarce resources from enforcement of current laws and would be unlikely to produce standards of best practices that would be as effective as those that the organizations themselves could establish. Moreover, because of its size and government regulatory procedures, it would be difficult for the IRS to obtain feedback on standards, evaluate standards, and amend standards on a frequent basis. Because development of best practices for nonprofit organizations is in its infancy, a system that facilitates changes and evolution over time is preferable.

We are concerned that having the IRS or any other government agency use the standards of best practices set by charitable organizations as standards for granting exempt status or allowing federal income tax deductions for donations could work at cross purposes to development of the highest standard of corporate governance. As we see it, the purpose of government and the purpose of accreditation organizations are different. Government is concerned with establishing minimum standards that must be met to obtain recognition of exempt status and government benefits or to avoid penalties. Accreditation organizations, at their best, should encourage excellence. Self regulatory groups might be discouraged from setting high standards if government benefits and penalties were tied to those standards. Moreover, reliance by the government on standards set by private organizations would appear to be an inappropriate delegation of governmental rulemaking authority to the private sector.

Establish prudent investor rules.

The Discussion Draft proposes to apply a federal prudent investor rule to the investment activities of charitable organizations. It notes that many states apply a prudent investor standard to nonprofit corporations formed in the state and suggests that such state standards would inform the development of a federal standard. The Discussion Draft does not discuss how such a rule would be enforced.

We assume that this proposal is intended to apply only to public charities. Private foundations are subject to a federal jeopardy investment rule, under Section 4944.

Most states, in their nonprofit corporation statutes, have a adopted a prudent person standard of care for directors in fulfilling their fiduciary duties generally.[19] With respect to the oversight of investments specifically, the American Law Institute's Restatement (Third) of Trusts and the Uniform Prudent Investor Act ("UPIA") provide a prudent investor rule, which is

[19] *See, e.g.*, Rev. Model Nonprofit Corporation Act (1987), which provides at Section 8.30 that a director shall discharge his or her duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation."

a refinement of the prudent person rule.[20] UPIA, at Section 2, imposes a standard of using "reasonable care, skill and caution." In addition, the majority of states have adopted the Uniform Management of Institutional Funds Act (UMIFA)[21] which applies to the endowment assets of "incorporated and unincorporated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes…" UMIFA, at Section 6, imposes an "ordinary business care and prudence" standard on a governing board in its oversight of investments.

Given the existence of these common law and state statutory standards, it is unclear what goals would be served by adding a federal standard in the context of public charities, or what specific issues a federal standard might be intended to address.

Funding of exempt organizations and for State enforcement and education.

The Discussion Draft proposes to dedicate some portion of the Section 4940 tax on private foundations to the Exempt Organizations Division of the IRS, restoring a legislative provision that was authorized in 1969 but never effectuated through appropriations. As an alternative, it might impose a filing fee on Form 990 filers, based on a portion of assets or gross receipts. Proceeds of these funds would be used for several purposes, including state enforcement for exempt organizations oversight, nonprofit education by state and/or national organizations, five year review of exempt status of charities, accreditation efforts, facilitation of public access to Forms 990, and establishment of an "exempt organizations hotline" for reporting abuses and complaints involving charities.

The Discussion Draft also proposes to permit information sharing with, and IRS referrals to, state attorneys general, the Federal Trade Commission, and the US Postal Service, with an annual report by the General Accounting Office to Congress on the results of such referrals.

The American Bar Association is a long-standing proponent of the provision of adequate funding for the IRS, including the Exempt Organizations Division.[22] When the comprehensive private foundation rules were enacted by Congress in 1969, there was a recognition of the importance of robust IRS enforcement of the charitable sector, and the lack of funding has been a continuing source of frustration of the IRS and the charitable sector alike. The solution proposed in the Discussion Draft – allowing at least a part of the private foundation excise tax revenues to be dedicated to that purpose – seems appropriate and allows, in effect, for a self-funding of IRS oversight of the charitable sector.

---

[20] Restatement (Third) Trusts, Prudent Investor Rule (1990) and Unif. Prudent Investor Act (1994) §§ 1-16 U.L.A. 280-311 (2004).

[21] Unif. Mgmt. of Inst. Funds Act (1972) § 1(1) 7A U.L.A. 484 (2004) (adopted in all states except Alaska, Arizona, Florida, Pennsylvania and South Dakota).

[22] For a recent example s*ee, e.g.,* Letter of April 23, 2004, from Richard A. Shaw, Chair, American Bar Association Section of Taxation, to the Senate Appropriations Subcommittee on Transportation/Treasury and General Government, stating that it is essential that the IRS have adequate funding to ensure its ability to carry out its mission in the administration and enforcement of the tax laws of the United States, available at www.abanet.org/tax/pubpolicy/2004/040423sen.pdf.

The proposal in the Discussion Draft that some of these funds be made available to state regulators also seems appropriate (assuming it would not detract from the funding needed by the IRS to regulate the sector), since greater state enforcement would be helpful in policing the charitable sector and yet is jeopardized by inadequate financial resources at the state level.

The use of a reasonable portion of these funds for educational purposes is also appropriate. The IRS Exempt Organizations Division has undertaken a number of new initiatives directed at meeting the educational needs of the sector, and we think it is possible that the funds proposed for this purpose would be more effectively used by the IRS than by state or national nonprofit organizations.

With respect to the establishment of an exempt organizations hotline, this seems to be a useful vehicle for communicating potential abuses involving exempt organizations. We understand that the IRS Exempt Organizations Division receives a significant number of referrals of potential abuses even without the existence of a formal hotline. Given the adversarial nature of many organizations in the charitable sector (pro life vs. pro choice, etc.), however, we recommend that consideration be given to the imposition of penalties in the case of misuse of the hotline for frivolous or fraudulent referrals.

State attorneys general have repeatedly called for greater sharing of information with the IRS, and it seems appropriate to authorize such sharing under certain circumstances and with appropriate safeguards.